Pharmacy Loan Covenants: What's in the Equation?

If you have a business loan that is secured by your pharmacy, chances are your lender has put in place a few covenants.

Loan covenants help the lender monitor the pharmacy or "their security asset" over the length of the loan. This is because the lender links your pharmacy's financial performance with the value of the security. A decline in the pharmacy's performance may result in the lender getting cold feet on the loan. Covenants provide a trigger for the lender to review your loan.

What is a Loan Covenant?

A **loan covenant** is a condition in a commercial **loan** that requires the borrower to fulfil certain conditions or which forbids the borrower from undertaking certain actions, or which possibly restricts certain activities to circumstances when other conditions are met. Their purpose is to help the lender ensure that the risk attached to the loan does not unexpectedly deteriorate prior to maturity. Proponents of the use of covenants, emphasising the early warning function of covenants, take the case further by arguing that well-designed covenants provide not only timely performance indicators but also open up lines of communication between borrower and lender.

This article should be seen as guild to assist you to become proactive when it comes to your loan covenants. YOU can use the covenants as a management tool to assess the performance of the business by management.

How and when are they set?

Usually, loan covenants are set when the loan commences. A lender will use historical and forecasted financial information to set a benchmark for the pharmacy. These benchmarks require the pharmacy to achieve certain hurdles to maintain the value at which they set the Loan to Value Ratio ("LVR").

The covenants are set either quarterly, semi-annually or yearly usually depending on the level of LVR. I have focused on the most common of these covenants, which are:

- **Minimum EBITDA.**
    - Lenders usually require the pharmacy to maintain a minimum Earnings Before Interest Tax Depreciation and Amortisation ("EBITDA") figure.

- You can work out the EBITDA from the profit & loss statement by taking your net profit after tax and adding to that figure, Tax, Depreciation, Interest and Amortisation.
- The EBITDA figure is generally set based on the valuation's EBITDA or on what the pharmacy did last year.
- By setting this covenant the bank is protecting the value of the pharmacy.

- **Gross Profit Margin**
    - Similar to the EBITDA covenant, the lender will set this covenant either based on the valuation of the pharmacy or on what the pharmacy did last year.
    - By setting this covenant the Bank is hoping that the business will maintain certain level of profitability.

- **Interest Cover Ratio ("ICR")**
    - Defined as the ability of the business to meet its interest expense from the Earnings Before Interest and Tax (EBIT).
    - This covenant requires a calculation taken from the profit and loss statement as follows: EBIT / Interest = X
    - The general rule for the lender is to set the covenant at 2 times.
    - This means that the pharmacy can meet (or pays) its interest costs 2 times over.

- **Debt Service Cover**
    - Defined as the ability of the business to meet its principal and interest payments from EBITDA.
    - Measured as dividing EBITDA by total principal and interest (P&I) payments.
    - This is applicable where debts are on a P&I basis.

There could be a number of other financial measures that may be set including stock turnover or the definition may vary by different lenders.

What's in the Equation?

In my experience, it is interesting to see how few pharmacists can pick up the P&L and calculate the EBITDA. Let alone, work out the Interest Cover Ratio.

Yet, they can tell me in an instance how many scripts they filled today.

When the lender asks for your financial information as part of meeting "your loan covenants," they are calculating the EBITDA, Gross Profit Margin and ICR as a minimum. If you do not know what the ratios are at the time you submit your financial information, it may be a case of Russian roulette as to what the lender does.

What if the lender comes back and says your EBITDA does not meet the minimum requirements?

Where does this leave you in the eyes of the lender?

Maybe it was just a case of putting a personal expense or one off expenses such as legal fees. It may have reduced your net profit, but is also reduced your EBITDA!

These one off expenses should be identified for the banker when the financials are being submitted to the bank.

Case Study – avoiding the breach.

A pharmacy loan had a covenant requiring the pharmacy to maintain a Gross Profit Margin of 30% or higher set on an annual basis. The June 30 numbers produced a Gross Profit Margin of only 29%. The result was the pharmacy receiving a breach notice from the lender for non-compliance.

In the end, the pharmacy was dispensing a diabetes drug with both a high sales price for the customer and a high cost for the pharmacy with a very low gross profit margin. When the sales of the drug were netted off with the Cost of Goods Sold, the result was an overall Gross Profit Margin for the pharmacy of more than 30%, thus meeting the loan covenant.

Understanding your loan covenant measurements is the key to avoid any nasty surprises, such as a breach letter from your lender. If the pharmacy analysed the numbers first and presented a case to the lender to mitigate the 29% Gross Profit Margin, then a breach letter may have been avoided all together.

In summary:

1. Know how to calculate the covenant.
   - Don't just rely on the lender to formulate their answer.
   - Be proactive with your covenant testing to ensure the relationship with your lender continues to stay healthy.
2. Ensure the covenants are set at a reasonable and achievable level at the start of the loan.
   - Making sure the covenants can be achieved from the onset of the loan makes for a better outcome in future.
   - It is no use for you or your lender to set an EBITDA based on unrealistic forecast. All that produces is a drama down the track as it runs the risk of being set up to breach the covenants when they fall due.
3. Keep a keen eye on the due dates of covenants.
   - The best thing you can do is know when your covenants are falling due.
   - That way, if there is a problem, you and your accountant or financial team can be proactive with the lender to resolve the situation before it goes any further.

It is best for business owners to be open and honest and discuss with their banker immediately a breach is determined. The bank genuinely wants to work with the business to get the best outcome for all parties.

About the Author

Manoj Miranda has worked in the healthcare banking industry for over 9 years. He has held senior management roles at National Australia Bank and Westpac and helped start up their banking proposition to the industry. Manoj has leading industry presence in the NSW healthcare banking industry market.

Prior to this Manoj worked for GE Commercial and Macquarie Bank in various Credit roles. Given the 20 years' experience in the finance sector in both Sales and Credit roles, asset finance, commercial and residential lending Manoj brings a wealth of experience to the healthcare market.

Credentials include a Master of Business (Finance) and MBA (Professional Accounting). He has also completed an Advance Diploma in Financial Planning.